

FEDERAL DEVELOPMENTS

IMPLEMENTATION OF RIEGLE-NEAL

During 1997, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) became fully implemented. Beginning on June 1, 1997, interstate branching became fully implemented: State and national banks in all states which had not opted out of interstate branching could establish and operate branches by merger or consolidation. On that date, the reciprocity provision in Michigan applicable to interstate branching by merger expired. State and national banks in states which opted out of interstate branching before June 1, 1997 were barred from branching by consolidation or merger or *de novo*. State and national banks located in states allowing interstate branching were precluded from branching into states which had opted out of interstate branching. The states which have opted out of interstate branching are Texas and Montana.

HUD RULES ON MORTGAGE BROKER FEES

On September 17, 1997, the Department of Housing and Urban Development (HUD) issued for comment a proposal intended to clarify the rules on mortgage broker compensation. Under the proposal, when homebuyers first meet with a mortgage broker, they would receive a one-page document (an "honest lending contract") stating the broker's fees and legal obligations to the borrower. The contract is intended to enable consumers to shop around for the best mortgage deal and save money in the process, according to HUD Secretary Andrew Cuomo. Much of the controversy centers around a practice by which some lenders allegedly paid additional fees to brokers for facilitating higher-rate loans. Several class action lawsuits have been filed against lenders, claiming that such practices violate the Real Estate Settlement Procedures Act.

The centerpiece of the proposal, the draft mortgage broker contract, features three boxes that a broker can check indicating to the borrower that the broker:

- represents the borrower,
- represents the borrower, but that the broker may receive a fee from the lender, or
- does not represent the borrower.

Some brokers fear that a broker checking either the first or second box would be deemed an agent and fiduciary of the borrower and would be required to obtain the most favorable mortgage loan for the borrower.

THE OCC RULE ON OPERATING SUBSIDIARIES AND THE FEDERAL RESERVE RESPONSE

In 1997, the Office of the Comptroller of the Currency (OCC) adopted an operating-subsidary rule establishing a way for national banks to create subsidiaries to underwrite securities, sell insurance, or conduct other activities which national banks may not do directly. The rule set the stage for national banks to engage in activities “incidental” to banking.

The new rule spurred some controversy when NationsBank filed an application with the OCC for permission to enter the real estate development business through a direct operating subsidiary. The Federal Reserve Board (the Fed) reacted to the application by charging that real estate development would be “incompatible with sound banking” and could expose banks to losses. The Fed argued that the thrift crisis had demonstrated the “imprudence” of allowing thrifts to engage in real estate development. In addition, the National Association of Realtors wrote letters in protest arguing that depository financial institutions lacked the necessary expertise and would suffer losses in real estate ventures. Other opponents argued that allowing banks to offer real estate development through subsidiaries could result in banks denying loans to a competitor or misusing information on a competitor which applies for a loan.

Later, the Fed issued a proposal that would apply sections 23a and 23b of the Federal Reserve Act to bank subsidiaries engaged in activities that the banks could not engage in directly such as securities underwriting and real estate development. Section 23a limits a bank’s investments in subsidiaries to 20 per cent of the bank’s capital and no single subsidiary may receive more than 10 per cent of capital. Section 23b requires arm’s length dealing, i.e., the bank is barred from providing discounted loans or other perks to the subsidiary. As legal authority for the move, Fed Governor Laurence Meyer said that Congress authorized the Fed to apply the capital requirements to bank subsidiaries when it amended the Bank Holding Act in 1982.

THE OCC/OTS AND TRUST ACTIVITIES

Following rulings in 1995 and 1996 by the Office of Thrift Supervision (OTS), several nonbank companies have sought thrift charters in order to offer trust services on an interstate basis. The OTS rulings preempt state restrictions and allow referral of clients in any state to thrift trust subsidiaries. Among the nonbank companies which have expanded their trust businesses through thrift charters are Merrill Lynch, Dean Witter, Morgan Stanley, and Discover & Co. Other organizations, including A.G. Edwards, Hartford Financial Services Group, and Paine-Webber Inc., are seeking to expand trust powers through thrift charters.

The implications for banks are far-reaching since with a thrift charter, a nonbank company such as a securities broker-dealer or an insurance company can compete more effectively for affluent customers.

Such customers will no longer have to leave their insurance company or broker-dealer to seek trust services from a bank. Some bankers fear that banks may lose in the competition for trust customers.

On December 30, 1996, the Office of the Comptroller (OCC) approved a rule relating to trust activities which took effect on January 29, 1997. The new rule eliminates several restrictions found in Part 9 of the OCC's rules. It eased restrictions on collective investment funds, removing a prohibition on an individual trust account comprising more than 10 per cent of a collective investment fund and dropping a provision which barred banks from putting more than 10 per cent of a fund into one investment. Reducing these restrictions brings collective investment funds into line with the less strict rules governing individual trust accounts. Trust managers of individual trust accounts must simply exercise "prudence" in diversifying investments. The OCC also eased restrictions governing what may be done with money awaiting investment.

In 1997, the OCC approved Banc One Corp.'s application to merge national banks in Wisconsin and Ohio which have trust operations. As of year end, the OCC had not acted on a CoreStates Financial Corp. application to establish a national bank that would centralize trust operations from several states without local oversight. In New Jersey, the Attorney General expressed concern about the lack of protection or legal recourse for CoreStates' trust customers.

THE FED'S EASING OF SECTION 20 "FIREWALLS"

Bankers have complained for years that section 20 firewalls were highly inefficient because of the required separation of people, products, and information between banks and their securities affiliates. After raising the ineligible revenue limit to 25 per cent, the Fed removed the remaining firewalls on October 31, 1997.

The move drew fire from Senator D'Amato who accused the Fed and the OCC of an "unwholesome competition" to lower the restrictions. He charged that it would be "dangerous overreaching" and he compared it to the lax regulatory treatment of thrifts in the early 1980s. The Fed defended its proposal arguing that existing banking and securities laws already outlaw banks from propping up section 20 affiliates. The Fed stated that banks under sections 23a and 23b of the Federal Reserve Act must collateralize loans to affiliates, charge market interest rates, and limit to 10 per cent of capital the amount a bank can lend to an affiliate. The Fed also cited as rationale that the firewalls impose restrictions that are not placed on investment firms. In this regard, the restrictions had made it difficult for small and medium size banking organizations to operate section 20 affiliates.

APPROVAL OF THRIFT CHARTERS FOR COMMERCIAL FIRMS

The pending financial reform legislation would require all federal thrifts to convert to banks within two years after passage with the special powers and ownership privileges of existing thrifts protected. Under one financial modernization proposal, that protection would be lost if the thrift is sold. Against this backdrop, in 1997, a number of insurance

companies, several of them among the nation's largest, have sought federal thrift charters. Since Congress began considering legislation to eliminate the thrift charter, the OTS has issued new charters to several insurers including — Reliastar Financial Corp., Principal Mutual Insurance Co., and Travelers Group. Amid all of the attention given to financial modernization by Congress, the approval of the Travelers Group application stands out. With its entry into the thrift business, Travelers Group, which had earlier moved aggressively into the securities industry with its purchase of Salomon Inc., will have become the first major, truly diversified financial firm. Undoubtedly, the recent flurry of applications for thrift charters and the other financial expansion that has occurred, reflects the view that Congress will grandfather the new expanded operations.

Among the other large insurance companies with pending applications to enter the thrift business, are John Hancock Mutual Life Insurance Co., Allstate Corp., American General Corp., State Farm Mutual Automobile Insurance Co., Transamerica Corp., Nationwide Insurance Enterprise, and Hartford Financial Services Group. It is interesting to note that these insurers join insurance companies such as Prudential Insurance Company of America, Amerus Life Insurance Co., and Acacia Mutual Life Insurance Co., which have operated thrift institutions for years.